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SUBJECT: THE SPIRALING PUBLIC DEBT: PART II

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¶1. SUMMARY. The government's intention to decrease the public deficit in 2006 and 2007 appears to be the first step towards the ultimate goal of reducing the national debt to 60% of GDP by 2010, as outlined in the Pebereau report, but thus far the proposed changes to the national budget remain short-sighted. The government's objective to reduce the budget deficit to 2.5% of GDP in 2007 relies heavily on streamlining spending, making the national budget more efficient and less expensive. The modest cuts in public sector employment and the 2.0-2.5% GDP growth found in government estimates, however, seem rather optimistic and, even if they were possible, would still be insufficient to reduce the 2007 budget deficit. The debate over reducing the national debt will surely make waves in Parliament in advance of next spring's presidential elections. End summary.

GOF Acknowledges Public Debt is Spiraling Out of Control

¶2. After reading the Pebereau report (ref A), Finance Minister Thierry Breton stated it was "possible to lower the public debt to less than 60% of GDP within five years through a combination of cuts in spending and the sale of assets." (Note: In this context, public debt is narrowly defined to exclude retirement pension liabilities. End note.) Later, at a conference, he acknowledged that government debt (broadly defined) was close to 120% of GDP or 2.2 trillion euros, including 900 billion euros in pension liabilities for public employees (civil servants, health workers, local authority employees) to be paid by 2030. Former finance minister and center-right UDF Senate Finance Commission President Jean Arthuis claimed the true debt total was "closer to 2.3 trillion euros" when the Post Office, Paris transport and railway companies are taken into account. He warned that the public debt liability of every newborn was close to 38,000 euros.

GOF Organizes Audits and Public Finances Conference

¶3. Since fall 2005, Finance Ministry experts have conducted 100 audits to decide about spending cuts in the central government budget. Breton concluded "it was possible to do better with less," giving some examples: a lower cost for analyses of finger prints (60 euros versus 300 euros) if Justice Ministry centralizes its purchases; 300-500 job cuts in Education due to a better organization of exams; 750 job cuts and 1.3 billion euros in spending cuts at the Finance Ministry thanks to internet-based income tax filing.

¶4. The government launched the first Public Finances Conference in

January 2006, "the starting point of a very active process to identify ways and means to put public finances on the getting-out-of-debt track," said De Villepin. He also announced the creation of the Council of Public Finances, a permanent working group. The Council suggested a gradual move toward "0% growth" in local government spending, and toward "1% growth" in social security spending. The government budget includes central government, local governments and the social security system.

Government Implements State Reform

¶5. Ministers have started to implement the State Reform ("Reforme de l'Etat"). Breton took the example of his ministry, citing the successful creation of a unique tax office ("guichet fiscal unique"), the implementation of internet-based income tax filing, and the distribution of income tax forms with key individual data already filled in to minimize errors and fraud. Parts of the ministry have signed contracts ("contrats de performance") committing to increase productivity. Breton promised to reward civil servants for their efforts by improving career perspectives, providing new social guarantees and incentives, including 120 euro premiums for high performance to civil servants as soon as 2006.

2007 Budget Plan to Cut Civil Servants Jobs

¶6. Breton's commitment to reduce the public debt to below 60% of GDP was obviously not met in 2005. Data released in March 2006 showed the public debt even higher than expected, increasing to 66.8% of GDP (889.2 billion euros), although the 2005 central government budget deficit was reduced to "exactly 2.87% of GDP", a performance in line with Breton's commitment to reduce the budget deficit to below the EU limit of 3% of GDP. Spending cuts, better management of central government short-term funds, and earlier corporate income tax down-payments helped. Otherwise, the 2005 budget deficit would have remained close to 3.4% of GDP, the

estimate made by Finance Ministry experts during summer 2005.

¶7. Wanting to remain positive, De Villepin said it would be possible to balance budget accounts and to reduce the public debt to below 60% of GDP by 2010. Breton and Budget Minister Cope said they worked hard as a team to reduce the budget deficit from 2.9% in 2005 to 2.8% of GDP in 2006 and 2.5% in 2007. Since June 18, Cope has been inviting internet users to step into his shoes by playing "cyber-budget" and see how difficult it is to reduce the deficit. (Fittingly, the prize will not be money. The first 50 winners may visit the finance ministry. The thousandth may meet Cope.) On June 22, Breton introduced the main outlines of the 2007 central government budget at the National Assembly, saying the government stuck to its 2.0-2.5% GDP forecast. He announced a cap on central government budget spending growth, restricting it to 0.8%, which meant a 1% real cut (assuming inflation of 1.8%), a significant change compared with the three previous years when the rule was "zero growth" in real terms. Most notably, the government plans to cut 15,000 civil service jobs. Wages, payroll taxes and pensions accounted for 44% of the central government budget spending (130 billion euros) in 2005, including 27.6% (35.9 billion euros) for pensions.

¶8. De Villepin promised more policemen and fewer teachers (due to declining school enrollments). About 19,000 jobs would be eliminated by not replacing all 80,000 civil servants who are scheduled to retire next year. The most affected would be Education (8,700), Defense (4,400), Finance (3,000) and Transportation (1,300). Productivity gains and cuts in budget spending will help finance 4,000 jobs in government priority areas - security, justice, university education and research (1,568) - after November 2005 unrest in suburbs, the fiasco of the Outreau affair (a miscarriage of justice that has forced France to reconsider its system of investigating magistrates) and the CPE (First Employment Contract) crisis. De Villepin said that cuts in budget spending would fund "the most ambitious tax reform of the last 25 years," making France a "normal" country compared with its European partners.

Reactions to Audits

¶9. Unions warn about the impact of job cuts on the quality of services. Socialist deputy and former budget spokesman Didier Migaud emphasized that "permanent audits would be more helpful than analyses made in a few weeks." Center-right UDF National Assembly Finance Commission member Charles de Courson argued that sending a few inspectors and experts to make audits contradicted the new public finances law (Loi organique relative aux lois de finances - LOLF) designed to give a new consistent framework to budget decisions.

Economists are Skeptical

¶10. Economists deemed the planned reduction in civil servants jobs as relatively modest compared to the 80,000 civil servants expected to retire next year. They were skeptical over whether plans expected to save 500-600 million euros would be put into action. Reductions have been difficult in 2006. The government promised to cut 10,000 civil servants jobs in 2006, but has now admitted this will be only 5,300. The government had to back off of to its 2002 objective to cut positions of one out of two retirees.

Criticism of the 2007 Budget from All Sides

¶11. Socialists criticized the government for cutting jobs while proposing a 3.6 billion euros tax break to middle classes, which will come into effect just a few weeks before next year's presidential election. Francois Hollande, Socialist Party leader, emphasized that "rather than cutting the number of civil servants in a purely ideological way, the government would be better off giving up its planned income tax reduction in 2007." Cope accused the Socialist Party of "permanent double talk" on public finances, saying he valued the cost of Socialist proposals at 115 billion euros, and Socialists did not specify how spending would be funded -"by raising taxes or increasing debt?"

¶12. Charles de Courson of the center-right UDF party stressed that the cap on budget spending was a sham since the 2007 budget would increase tax exemptions ("depenses fiscales") to 61 billion euros from 51.6 billion euros in 2004, and other elements of the budget (transfers to state-owned companies, and use of receipts) were just lax government fiscal policy. Cope replied that, given their nature, tax exemptions could not be compared directly with budget spending growth. National Assembly budget spokesman Gilles Carrez of the center-right UMP majority party estimated that reducing the

public deficit to 2.5% of GDP would be possible only "in an optimistic scenario" of 2.5% GDP growth in 2006 and 3% growth in
¶2007. He found more realistic the 2% GDP forecast recently made by the National Statistical Agency INSEE (ref B). Philippe Marini, the UMP Senate's spokesman on the 2007 budget debate, stressed that "the more or less unanimous talking about the necessity of reducing public debt, has not yet had a practical impact."

¶13. Philippe Seguin, the head of the authority in charge of overseeing public finances, the Cour des Comptes, characterized as "symbolic" the cut in the civil service, calling for "a permanent effort to reduce deficit and debt." He suggested 30 billion euros in spending cuts to avoid the "vicious spiral" of indebtedness. He denounced the increase in tax exemptions, and sales of government assets used "to conceal" budget deficits. He criticized the government for its "lack of long-term fiscal policy and a vision flaw." He suggested implementing new schemes to ensure a durable improvement in public finances by balancing social security accounts, notably with a better use of new technologies and seriously controlling spending.

The EU Commission Encourages Fiscal Consolidation

¶14. On June 2, Joaquim Alumnia, the EU Commissioner for economic and monetary issues, reiterated fears about insufficient efforts made by France to reduce budget deficits. According to the Commission, the French budget deficit would increase to 3% of GDP in 2006 and 3.1% in 2007 if nothing was done. However, the government won praise from Alumnia for its 2007 budget plan. He said that "fiscal

consolidation launched in 2005 and 2006 could be sustainable in
¶2007. In that case, France will be one of the countries that will no longer have an excessive budget deficit."

Comment

¶15. It would take four years to balance the central budget deficit and to reduce the public debt to 60% of GDP if all recommendations of the Pebereau report were strictly followed. The government agreed with this deadline and was inspired by some of its recommendations, but nonetheless, has a short-term vision, focused on the 2007 presidential elections. 2.0-2.5% GDP growth in 2007 looks both optimistic and insufficient to reduce the budget deficit. The government target for cutting the civil service in 2007 is very modest, but the CPE crisis and upcoming presidential elections impede any major reform.

STAPLETON